

***United States Court of Appeals
for the Second Circuit***



**BRIEF FOR
APPELLEE**

Signed

77-4092

IN THE UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

HARDER SERVICES, INC.
(Formerly: Harder Extermination Service, Inc.),

Appellant

v.

COMMISSIONER OF INTERNAL REVENUE,

Appellee

ON APPEAL FROM THE DECISION OF
THE UNITED STATES TAX COURT

BRIEF FOR THE APPELLEE

M. CARR FERGUSON,
Assistant Attorney General,

GILBERT E. ANDREWS,
JONATHAN S. COHEN,
JAMES E. CROWE, JR.,
Attorneys,
Tax Division,
Department of Justice,
Washington, D. C. 20530.

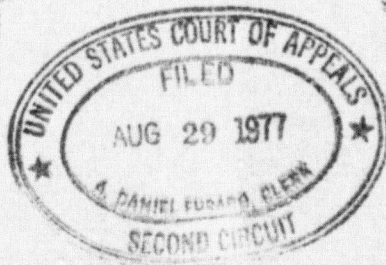


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(Formerly: Harder Extermination Service, Inc.),

Appellant

v.

COMMISSIONER OF INTERNAL REVENUE,

Appellee

ON APPEAL FROM THE DECISION OF
THE UNITED STATES TAX COURT

BRIEF FOR THE APPELLEE

STATEMENT OF THE ISSUES PRESENTED

1. Whether the redemption by a corporation of its own stock from a minority shareholder constitutes a transaction with respect to which neither gain nor loss could be recognized by the corporation under Section 311 of the Internal Revenue Code of 1954, and thus does not qualify as an ordinary and necessary business expense under Section 162 of the Code.

2. Whether, in the alternative, under the "origin of the claim" doctrine of Woodward, the redemption of stock incident to a planned merger of two corporations is itself a capital transaction, and the redemption payment is therefore nondeductible as a business expense.

3. Whether the Tax Court correctly decided that the redemption payment to the minority shareholder was not, in effect, additional investment in a subsidiary corporation which, upon becoming worthless, would be deductible in full as an ordinary loss under Section 165(g)(3) of the Code.

STATEMENT OF THE CASE

This appeal involves \$17,666.75 in federal income taxes for the years 1964, 1965, 1966 and 1968. (R. 5.) The Tax Court (Judge Fay) entered its opinion, which is officially reported at 67 T.C. 585, on December 27, 1976. (R. 4.)^{1/} A decision in favor of the Commissioner was entered on December 29, 1976. (R. 3.) Taxpayer filed a timely notice of appeal on March 25, 1977. (R. 2.) Jurisdiction is conferred upon this Court by Section 7482 of the Internal Revenue Code of 1954.

The facts pertinent to this appeal, as found by the Tax Court (R. 6-15) and as otherwise appearing of record, may be summarized as follows:

Harder Services, Inc., the taxpayer herein, is a New York corporation with its principal office in Hempstead, New York. (R. 6, 33.) The taxpayer's corporate entity grew out of a merger

^{1/} "R." references are to the separately bound record appendix. Other references will be to the exhibits entered in evidence below (some of which are reproduced in an exhibits volume of the record appendix) and portions of the transcript ("Tr.") not contained in the record appendix.

in 1968 of a number of separate companies owned by the family of F. Kenneth Harder (Mr. Harder).^{2/} (R. 7, 34.)

Over the years prior to 1964, the Harder corporations were engaged largely in the pest control and tree service business in the New York City metropolitan area. (R. 7, 64.)

In 1964 the Harders began to consider the acquisition of an office maintenance and cleaning company. They believed that such acquisition would complement their pest control operations and put them in a better position to compete with larger companies which offered pest control services as part of, or in addition to, their normal office cleaning services. In a discussion between Mr. Harder and his son Frank, who was also involved in the business activities, it was suggested that one possible acquisition might be Cardinal Maintenance Corp., the firm which had the cleaning contract on the Harder offices. The owner of Cardinal Maintenance Corp. was Philip A. Rogers, whom the Harders had known for many years. Rogers was the brother-in-law of Richard Valentine, an attorney whom the Harders had known since he was a child. (R. 7-8, 67-72, 84-85.)

Frank then broached the subject to Rogers, who was receptive to the idea of his company's becoming part of the Harder organization. Eventually the details of a possible merger transaction involving

^{2/} At the merger in 1968, the surviving corporation was named Harder Extermination Service, Inc. Its corporate name was subsequently changed to Harder Services, Inc. (R. 34.) In the court below, the taxpayer contended that it was not subject to transferee liability for the tax deficiencies determined against Harder Tree Service, Inc. (one of the merged corporations), for the years in question. The Tax Court rejected this claim (R. 29-32), and the taxpayer (Br. 4) does not appeal that determination.

Cardinal Maintenance and Harder Tree Service, Inc. (Harder Tree) (one of the Harder companies), was discussed by Frank, Rogers and Valentine. The documents were prepared by Valentine. Since Valentine had in the past served as attorney for both Rogers and the Harders in other matters, he was the only attorney involved in the merger planning, and he purported to represent both sides in the proposed merger transaction. (R. 8, 84-85.) Mr. Harder did not concern himself with the details of the transaction which he left up to Valentine. (R. 8, 72.)

Valentine prepared the documents for the transaction and presented them to the Harders for review on July 23, 1964. The documents were reviewed by Mr. Harder and Frank and by another officer of the Harder companies, as well as the Harders' outside accountant. On July 31, 1964, a closing was held, attended by Mr. Harder, Frank, their accountant, Rogers and Valentine. At the closing Valentine reviewed the Agreement of Merger with all of the persons attending. (R. 8-9, 43-45, 72-75, 86-87; Stip. Ex. 2-B; Pet. Ex. 30, p. 13.)

The relevant provisions of the merger plan executed July 31, 1964, may be summarized as follows: Rogers' company, Cardinal Maintenance Corp. (Old Cardinal), was merged into Harder Tree and the stock of Old Cardinal was cancelled. Twenty-two shares of Harder Tree common stock were issued to Rogers, representing 11 percent of the total of 200 Harder Tree shares outstanding. The balance of such outstanding shares was owned by the Harders. Concurrently, Harder Tree created a new wholly-owned subsidiary

^{3/} named Cardinal Maintenance, Inc. The assets and business acquired by Harder Tree in the merger were contributed as capital to the newly-created subsidiary. (R. 9, 34-35; Stip. Ex. 2-B (Ex. E); Stip. Ex. 7-G.)

At the time of the merger closing Harder Tree entered into an employment contract with Rogers, at a minimum salary of \$1,000 per month; he was to give his best effort and skill exclusively to the business and interests of Harder Tree and its affiliates; he was to be precluded from competing with Harder Tree's or Cardinal's business for five years after he terminated his employment; and he was to be precluded from divulging trade secrets during his employment and for five years after termination of his employment. Either party had the right to cancel and terminate the employment upon two weeks' notice to the other. (R. 10; Stip. Ex. 8-H.) Rogers was also elected a director and vice-president of Harder Tree. (R. 10; Stip. Ex. 10-J (Minutes of Harder Tree's special board of directors' meeting of July 23, 1964).)

As an integral part of the merger transaction there was also executed a "Stock Option Agreement" between Harder Tree Service, Inc.; F. Kenneth Harder, and Philip A. Rogers. (Stip. Ex. 2-B. p. 7.) Among other things, that agreement provided a grant to Harder Tree of an option to purchase any or all of the shares of

^{3/} Hereinafter sometimes referred to as "Cardinal." This newly created subsidiary of Harder Tree is to be distinguished in name from Rogers' former company, Cardinal Maintenance Corp. (hereinafter sometimes referred to as "Old Cardinal"), which was merged into Harder Tree. (R. 9.)

stock of Harder Tree owned by Rogers for a period of six months commencing with the date of termination of Rogers' employment with Harder Tree for any reason. Harder Tree granted to Rogers, or his trustees, an option to sell to Harder Tree all or any part of the shares of stock of Harder Tree owned by Rogers for a period of six months commencing on the date of Rogers' death; for a period of six months commencing with the date of termination of Rogers' employment with Harder Tree for any reason other than death, or his resignation as an employee of Harder Tree; or for a period of six months from the date of Rogers' resignation because Rogers' annual rate of salary, excluding bonuses, in the two calendar years immediately preceding the date of his resignation was below \$12,000. The option price to be paid by Harder Tree in the event that Harder Tree or Rogers exercised their options was an amount determined by:

(a) Multiplying the value of all the outstanding stock of Harder Tree by a fraction of which the numerator is the number of shares being sold and the denominator is the total number of shares of Harder Tree outstanding.

(b) The value of all the outstanding stock of Harder Tree was to be an amount equal to the average annual gross receipts of Harder Tree and of its subsidiaries on a consolidated basis for 12 calendar months ending on the last day of the calendar month immediately preceding the month in which the right to exercise arose, except that if the right to exercise arose

prior to August 1, 1967, such value was to be an amount equal to such annual gross receipts for 12 calendar months. (R. 10-12; Stip. Ex. 9-I.)

For the first two years following the merger transaction Cardinal failed to operate profitably, although realizing substantial gross sales. For the calendar year 1966, Cardinal had sales of \$541,139.58 and its parent, Harder Tree, had sales of \$374,109.85.^{4/} (R. 12; Stip. Ex. 17-Q.)

During 1966 the Harders' accountant, Keith Baker, recommended to Mr. Harder that all of the several Harder companies be merged into a single entity for administrative and accounting reasons and for possible financial and tax benefits. In the course of analyzing the feasibility of such a combination, Baker had occasion to review the employment and option agreements executed in 1964 between Harder Tree and Rogers. (R. 12-13, 49-50.) In November, 1966, Baker sent a memorandum to Mr. Harder expressing the opinion that if the desired merger of the Harder companies were to be accomplished the Rogers stock option agreement must be cancelled and a new agreement negotiated, for the following reasons:

1. In a merger, Harder Tree would be dissolved and no longer be a party to the agreement.

^{4/} This figure for Harder Tree's gross sales in 1966 is taken from the accountant's computation of the purchase price pursuant to the stock option agreement when Harder Tree, in 1967, exercised its option to repurchase its 22 shares from Rogers. (Stip. Ex. 17-Q.) This gross sales figure does not square with the gross sales figure of \$451,284 shown on Harder Tree's corporate income tax return for 1966. (Stip. Ex. 20-T.) The parties accepted the lower figure shown on Stipulated Exhibit 17-Q for purposes of the stock repurchase. There is no explanation in the record for the discrepancy in the figures.

2. The consolidated sales of Harder Tree and Cardinal would become commingled with the sales of the other Harder companies, thus rendering inoperable the method prescribed for the valuation of stock under the option agreement.

3. Rogers would become the owner of stock of the merged company, thereby acquiring an interest in the assets and profits of all five of the Harder companies, rather than just his interest in the operations of Harder Tree and Cardinal.

4. The valuation method prescribed in the option agreement was improper since it is based upon gross sales, presumably upon the original assumption that such sales would yield normal rates of profit, increasing as sales increase, whereas in the case of Cardinal no significant profits had been realized after more than two years of operations.

5. The continued existence of the option agreement would probably foreclose the newly merged company from obtaining major debt or equity financing.

(R. 13-14; Pet. Ex. 31.)

At this time, Mr. Harder and Frank realized the significance of the valuation method prescribed in the 1964 Rogers option agreement. Although they had both reviewed the agreement prior to its execution, they had failed to realize that an option price formula based upon gross sales without regard to net income might

result in a price totally unrelated to the true value of the stock. In reviewing the 1964 merger documents, the Harders had relied heavily upon their confidence in Valentine, the trusted attorney and friend of both parties to the agreement. (R. 14, 75-78, 88.)

After receiving Baker's memorandum concerning the Rogers' stock option agreement, and in light of the fact that the Cardinal operation, managed by Rogers, was not profitable, Mr. Harder determined that it would be necessary to terminate the relationship with Rogers. (R. 78-80.) Although the 1964 employment agreement provided for termination by either party, the stock option agreement provided that if Rogers' employment was to be terminated by Harder Tree, Rogers could force Harder Tree to repurchase his 22 shares of Harder Tree stock at a price determined by the formula keyed to gross sales. (Stip. Ex. 9-I, par. 3.) If Rogers was to be dismissed at the end of 1966, the repurchase price under the formula would be \$100,677.44, an amount which the Harders considered totally unrelated to the true value of Rogers' 22 shares. (R. 14-15, 78, 89; Stip. Ex. 17-Q.)

At this point, Mr. Harder retained Alfred A. Marra, an attorney, to advise him with respect to the Rogers situation. Marra reviewed the entire history of the 1964 transaction, and formed an opinion that the stock option agreement should be abrogated on the basis that Valentine should not have represented both sides of the transaction and that the valuation formula under the agreement drafted by Valentine was unconscionable since it was based

on gross sales and not on net earnings. Marra recommended in the strongest terms that the Harders take the matter to the courts and seek to have the agreement voided. (R. 15-16, 79-81, 89, 103-104.) Mark Wood, treasurer of Harder Tree, also had reservations about the formula and thought that the formula price for the stock was completely out of line with its true value. He brought this matter to the attention of, and discussed it with, Mr. Harder and Frank. (R. 16; Pet. Ex. 30, pp. 17-18, 28.)

But, because of the involvement of Valentine, who had been a long-time friend of the Harders and who was Rogers' brother-in-law, the Harders did not wish to litigate the matter. Among other considerations, they felt that the Valentine family was too wealthy and powerful to take on in a court battle, and that such litigation might ultimately be harmful to their business. Accordingly, the Harders decided to resolve the matter by simply paying Rogers the \$100,677.44 formula repurchase price for his stock, although they believed such price to be considerably in excess of the true value of such stock. (R. 16, 81, 89, 105.)

Thus, in January, 1967, Harder Tree formally terminated the employment of Rogers and exercised its option to purchase his stock. In February, 1967, Harder Tree paid Rogers \$100,677.44, Rogers delivered his 22 shares to Harder Tree, and Rogers was removed as an officer and director of both Harder Tree and Cardinal. (R. 16; Stip. Exs. 12-L through 16-P.)

In September, 1967, the Harders took steps to sell the business and the assets of Cardinal, and in December, 1967, Cardinal was formally dissolved. (R. 17; Stip. Ex. 10-J (Minutes of board meetings of Sept. 1 and Dec. 6, 1967); Stip. Ex. 11-K (Minutes of board meetings of Sept. 1 and Dec. 19, 1967); Stip. Ex. 28-BB.)

The \$100,677.44 paid by Harder Tree to Rogers in 1967 was treated on the books of Harder Tree as an additional investment in its subsidiary, Cardinal, bringing its total basis in its Cardinal investment to \$103,520.60. On its income tax return for 1967 Harder Tree claimed a total deduction of \$110,563.30^{5/} based on the "investment in and advances to Cardinal Maintenance, Inc.--a wholly owned subsidiary dissolved in 1967." (R. 17-18, 38; Stip. Ex. 21-U.)

Harder Tree's 1967 return reported a net loss of \$108,670.13, taking into account the above-mentioned deduction of \$110,563.30 with respect to Cardinal. This net loss was then applied as a net operating loss carryback and carryforward to reduce the net income of Harder Tree (and its successor) for the years 1964 through 1966 and 1968 through 1972. The Commissioner adjusted the reported 1967 net

^{5/} This amount claimed was computed as follows (R. 18, 38; Stip. Ex. 21-U):

Total amount treated as capital contributions to Cardinal (i.e., basis of investment)	\$103,520.60
Uncollectible liability from Cardinal to Harder Tree	<u>7,042.70</u>
Total	\$110,563.30

loss and resulting carryover and carryback deductions for 1964 through 1966 and 1968 to the extent of \$100,677.44, the portion of the written-off investment in Cardinal representing the payment to Rogers in January, 1967. (R. 18, 39-40.)

In bringing this action, the taxpayer reasserted the claim that the payment to Rogers for the repurchase of Harder Tree stock constituted additional investment in Cardinal. (Pet. par. 5(m).) The taxpayer thereby attempted to qualify the entire payment for a deduction under Section 165(g)(3) of the Code as a loss, in 1967, on the worthlessness of Cardinal's stock, a wholly owned subsidiary. The taxpayer added the further contention that the payment constituted additional compensation to Rogers, thereby qualifying it as a business expense under Section 162 of the Code. (Pet. par. 5(1)-(m).) After the trial below, the taxpayer, in its post-trial brief, made, for the first time, a third argument to the effect that the payment was deductible under Section 162 since it was made to terminate Rogers' rights under the stock option agreement, which represented an onerous, ongoing contingency adversely affecting Harder Tree's business. (Tr. 12; Pet. Br. 31-32.)

The Tax Court rejected the taxpayer's arguments. Principally, the court below found that the origin of the payment to Rogers stemmed from Harder Tree's corporate reorganization plans and did not involve Harder Tree's survival as a business entity. (R. 25-26.) The court further found that the payment could in no

sense be considered compensation to Rogers since the origin of the payment was not termination of Roger's employment but the termination of his equity interest in Harder Tree to facilitate the merger of the Harder companies. (R. 26-28.) Finally, the Tax Court found the taxpayer's argument under Section 165(g)(3) to be without merit. (R. 20.) Decision was, accordingly, entered in favor of the Commissioner, and this appeal follows.^{6/}

^{6/} The further issue of taxpayer's liability as a transferee was litigated below and resolved adversely to taxpayer. Taxpayer is not raising the point on appeal. (Br. 4.)

SUMMARY OF ARGUMENT

This case presents the question of the characterization for tax purposes of Harder Tree's payment in 1967 of \$100,677.44 to Rogers in exchange for all of Rogers' common stock in Harder Tree. The taxpayer claims, in the alternative, that the payment is deductible as a business expense under Section 162 of the Internal Revenue Code of 1954, or that it is deductible as an ordinary loss under Section 165(g)(3). The claimed business expense deduction is justified on the basis that either the payment was made to remove an onerous contract that threatened Harder Tree's business survival, or it constituted compensation to Rogers on the termination of his employment by Harder Tree. The taxpayer contends under Section 165(g)(3) that the payment constituted additional capital investment in Cardinal, Harder Tree's wholly owned subsidiary, whose stock allegedly became worthless in 1967. The Tax Court correctly rejected these contentions and ruled for the Commissioner.

1. Section 311(a) of the Code provides the general rule that no gain or loss shall be recognized to a corporation on distributions of property (including cash) made by it with respect to its stock, which includes redemptions. Section 311 was enacted in 1954 to establish a uniform rule for a corporation's transactions with respect to its own stock and, since the payment in question was undisputably made to Rogers by Harder Tree for the purchase of

the Harder Tree stock held by Rogers, Section 311, we submit, should be dispositive as a matter of law of the taxpayer's claims for recognizable losses in any form.

2. Quite apart from the interdiction of Section 311(a), the payment here is a nondeductible outlay originating in a capital transaction. The taxpayer urges this Court to adopt a broad rule that any payment by a corporation, when made to relieve it of a contingent obligation, should qualify as an ordinary and necessary business expense, even where the payment is made for the redemption of the corporation's stock. The "onerous" liability in the instant case was the stock option agreement with Rogers that served to impede the Harders' desired merger. The Tax Court rejected such a broad formulation and, instead, applied the "origin and character" of the claim test prescribed in Woodward v. Commissioner, 397 U.S. 572 (1970), to distinguish between expenses that are deductible and those that are capital in nature. Pursuant to this test, an expense must be capitalized where it originates in an essentially capital transaction (i.e., the acquisition of a capital asset). The thrust of the old cases relied upon by the taxpayer, which permitted a business deduction where payment was made to insure the survival of the business, has been seriously undermined, if not completely eliminated, by the Woodward test, which has since been uniformly applied in cases similar to that here presented.

The Tax Court's finding that Harder Tree's purchase originated in the company's merger plans is fully supported by the record (particularly by the accountant's memorandum citing the stock option agreement as the chief obstacle to the merger). Expenses relating to mergers and recapitalizations are generally capitalized, and the record clearly shows that the exercise of its rights under the stock option agreement by Harder Tree was done to facilitate the subsequent merger of the Harder companies.

The taxpayer argues that Cardinal constituted a financial drain on Harder Tree and attempts to tie Cardinal's dissolution to the stock purchase as necessary prerequisites to Harder Tree's survival. There is absolutely no reason, however, to link the subsequent dissolution of Cardinal with the purchase of Rogers' stock. While the record shows that the Harders desired to do both to pave the way for the merger, Harder Tree's stock purchase under the option agreement could have been, and was, accomplished without any necessary impact on Cardinal. In short, Harder Tree's "survival" was never at stake. It purchased Rogers' stock merely to help achieve the advantageous financial benefits stemming from operating in reorganized form. If the Cardinal operation threatened its survival, Harder Tree could have dissolved it without necessitating a payment to Rogers.

3. The Tax Court also correctly rejected the argument that the payment constituted, in part, termination pay to Rogers, thereby denying a business deduction claimed for compensation

paid under Section 162. While the parties' rights under the stock option agreement were triggered by the termination of Rogers' employment, the Tax Court's finding that Harder Tree's payment originated in the need to eliminate Rogers' equity interest to facilitate the merger is dispositive of this contention by the taxpayer.

In any event, the "compensation" deduction should be denied the taxpayer since it made no showing that this extraordinary payment was "reasonable" in amount and related to personal services actually rendered. Harder Tree and Rogers entered into an employment contract separate from the stock option agreement. The employment contract established Rogers' salary (approximately \$12,000 per year), and there is absolutely no indication in the record, either in the form of Harder Tree business records or in the testimony of its officers, that Rogers was paid for personal services other than under the employment agreement. Furthermore, a payment of \$100,000 could not be justified on any of the accepted criteria governing the "reasonableness" of compensation deductible under Section 162.

4. The taxpayer's contention that it is entitled to an ordinary loss deduction under Section 165(g)(3) in the amount of the payment to Rogers falls almost of its own weight. To even reach this issue, this Court must decide that Harder Tree's payment to Rogers was, in substance, an additional capital investment in Cardinal. As shown, supra, however, the payment to Rogers and the dissolution of Cardinal were mutually exclusive events, both in time and in legal effect. Rogers was a share-

holder in Harder Tree, not Cardinal. There was no agreement linking Rogers and Cardinal in any way. The stock option agreement involved only Rogers, Mr. Harder and Harder Tree. It is inconceivable, then, that Harder Tree's payment to Rogers could in any way be deemed a contribution to Cardinal's capital. The payment was made exclusively to extinguish Harder Tree's and Rogers' rights under the agreement.

The decision of the Tax Court should be affirmed.

ARGUMENT

THE TAX COURT CORRECTLY DECIDED THAT HARDER TREE WAS NOT ENTITLED TO A DEDUCTION FOR THE PAYMENT MADE TO REPURCHASE ITS OWN STOCK

- A. Harder Tree's purchase of its own stock from Rogers constituted a transaction under Section 311 of the Code, whereby no gain or loss could be recognized by the corporation as a matter of law

Section 311(a) of the Internal Revenue Code of 1954 (26 U.S.C.), Appendix, infra, provides that, barring exceptions not here applicable, "no gain or loss shall be recognized to a corporation on the distribution, with respect to its stock, of * * * (2) property." Treasury Regulations on Income Tax (1954 Code) Section 1.311-1(a) (26 C.F.R.) provides that a distribution made in redemption of stock by a corporation shall be treated as a "distribution with respect to its stock."^{7/} Since Harder Tree's purchase of its stock from Rogers for a cash payment of \$100,677.44 was clearly a redemption that constituted a complete termination of Rogers' interest in Harder Tree (see Sections 302(b)(3) and 317), it was a "distribution" under Section 311(a), on which neither gain nor loss can be recognized. Accordingly,

7/ Prior to the enactment of the 1954 Code, case law established that a purchase by a corporation of its own stock for cash resulted in no gain or loss to the corporation. Simmons & Hammond Manufacturing Co. v. Commissioner, 1 B.T.A. 803, 807-808 (1925); Hutchins Lumber & Storage Co. v. Commissioner, 4 B.T.A. 705, 710-711 (1926). See also Jewel Tea Co. v. United States, 15 F. Supp. 56 (S.D. N.Y., 1936), aff'd, 90 F. 2d 451 (C.A. 2, 1937). But exceptions to this rule were carved out where the corporation purchased its stock from shareholders with appreciated property or for speculative gain. See e.g., Commissioner v. S. A. Woods Mach. Co., 57 F. 2d 635 (C.A. 1, 1932), cert. denied, 287 U.S. 613 (1932). See also United States v. Anderson, Clayton & Co., 350 U.S. 55, 60 (1955).

Section 311(a) of the Code was subsequently enacted as part of the 1954 Code to clarify the case law that grew up in this area. See S. Rep. No. 1662, 83d Cong., 2d Sess., p. 247 (3 U.S. Code

as a matter of law, we submit that Harder Tree can derive no tax benefit from the transaction. Cf. H. and G. Industries, Inc. v. Commissioner, 495 F. 2d 653, 657 (C.A. 3, 1974).^{8/}

The taxpayer presses the argument (Br. 30-32) that the substance of the transaction should prevail over its form and, as a result, that either the cash payment to Rogers was, in effect, an added capital investment in Cardinal, with that corporation's stock becoming worthless in 1967, or the payment was made for the allegedly deductible purpose of ridding Harder Tree of an onerous contract. While these points will be taken up in detail, infra, it is sufficient here to note that the Commissioner's tax treatment of this transaction merely follows the manner chosen by Harder Tree. The record unquestionably shows that Harder Tree "purchased" Rogers' 22 shares of its stock in 1967 for \$100,677.44. (Stip. Exs. 13-M, 16-P.) The fact that the purchase may have served some business purpose of Harder Tree would not serve to alter the clear application of Section 311(a).

7/ (continued):

Cong. & Adm. News (1954) 4621, 4884); 7 Mertens, Law of Federal Income Taxation (Rev. 1976) § 38.29. Section 311(a) can properly be viewed as extending the pre-1954 Code nonrecognition rule involving a corporation's purchase of its stock for cash to include other purchase variations not specifically excluded under other provisions of Section 311. But the transaction before this Court in the instant case would be resolved in the same manner under either Section 311(a) or the pre-1954 Code rules. It is a simple case of a corporation using cash to purchase shares of its stock from a minority shareholder. See White Star Drive-In Laundry and Cleaners, Inc. v. United States, 72-2 U.S.T.C., par. 9683 (N.D. Ill., 1972).

8/ While H. and G. Industries concededly stops short of holding that Section 311(a) absolutely prohibits deduction under Section 162 of a redemption distribution, we submit that such an interpretation of Section 311(a) is nonetheless entirely sound.

See United States v. Anderson, Clayton & Co., 350 U.S. 55, 60 (1955). Harder Tree did not recognize gain or loss when it issued its 22 shares to Rogers in exchange for his 10 shares of Old Cardinal stock pursuant to the merger in 1964. (Stip. Ex. 2-B (Ex. E).) See Sec. 1032; Commissioner v. Fender Sales, Inc., 338 F. 2d 924, 930 (C.A. 9, 1965); Carroll-McCreary Co. v. Commissioner, 124 F. 2d 303 (C.A. 2, 1941). Likewise, the taxpayer should not now, in a post-transactional reconstruction of the 1967 purchase, be permitted to avoid the characterization of Harder Tree's redemption of those same shares as a capital transaction which, under Section 311, could not give rise to a recognizable loss.^{9/}

^{9/} In its brief (pp. 21, 41), the taxpayer states for the first time in this litigation that Harder Tree obtained the money to purchase Rogers' shares by a loan from Harder Extermination Service, Inc., which, in turn, had received the money from Mr. Harder. Notwithstanding the point that this information was not adduced in the court below, it is well established that the capital nature of a corporation's repurchase of its stock for cash is not altered by the fact that it used borrowed funds to make the purchase (Hutchins Lumber & Storage Co. v. Commissioner, supra).

- B. Quite apart from Section 311(a), the payment to Rogers did not constitute a deductible business expense for Harder Tree
1. The Tax Court's determination that the payment originated in the reorganization of the Harder companies is not clearly erroneous

The taxpayer (Br. 33-47) urges this Court to adopt the "broad principle" (Br. 36) that a corporation is entitled to a business deduction under Section 162 of the Code for payments made to relieve itself of a contingent obligation, even though the transaction takes the form of acquiring its stock from one of its shareholders, citing in support of its position United States v. Smith, 418 F. 2d 589 (C.A. 5, 1969); Five Star Manufacturing Co. v. Commissioner, 355 F. 2d 724 (C.A. 5, 1966); and Capitol Indemnity Ins. Co. v. Commissioner, 237 F. 2d 901 (C.A. 7, 1956). In rejecting this contention, the Tax Court (R. 22-26) properly applied the "origin of the claim" test enunciated more recently by the Supreme Court to govern the distinction between business and capital expenses. See Woodward v. Commissioner, 397 U.S. 572, 577-579 (1970). See also, United States v. Gilmore, 372 U.S. 39 (1963); Estate of Meade v. Commissioner, 489 F. 2d 161 (C.A. 5, 1974), cert. denied, 419 U.S. 882 (1974). Following this principle, the court below found that the payment to Rogers originated in the plans for merging the Harder companies, thereby requiring capital (nondeductible) treatment of the transaction. Contrary to the taxpayer's contention (Br. 33), the Tax Court applied the correct legal principles to this case, and its factual findings are wholly supportable under the "clearly erroneous" standard of appellate review.

The legal context of the Tax Court's rationale can best be viewed by first looking to the line of cases urged upon this Court by the taxpayer. In Five Star Manufacturing Co. v. Commissioner, supra, a corporation was held to be entitled to an expense deduction for payments made to purchase all of its shares from one of its two 50 percent shareholders. There, the corporation's principle intangible asset was a patent licensing agreement that permitted it to build heaters. The holder of the patent obtained a judgment against the corporation in which the licensing agreement was set aside, and the corporation was unable to manufacture and sell the heaters. The holder refused to renegotiate the agreement with the corporation as long as a certain shareholder maintained his interest in it. The corporation terminated this shareholder's interest by purchasing his stock. In permitting the business deduction for this payment, the Fifth Circuit stressed the extraordinary factual situation which showed that, pursuant to the judgment held by the patent's owner, the corporation had lost its right to manufacture and sell its product, the corporation's assets had been attached and the corporation, which was without working capital, faced liquidation and bankruptcy.

While not involving the purchase of stock from its shareholders, the Capitol Indemnity Insurance and the Smith cases, supra, involve variations on the theme found in Five Star. In the former, an insurance company had entered into an exclusive

agency agreement whereby one person (and his corporation) was entitled to sell its policies. The agency was unprofitable and the insurance company could not have remained in business without cancelling the agency agreement. This was done and, because of other contractual complexities, the company was required to make payments to certain of its founding shareholders. These payments were found to be deductible business expenses and not dividends.

Similarly, in Smith, the Fifth Circuit ruled that the payment by a corporation to a person who was adjudicated to be a partner in a predecessor partnership could be deducted where it was made to save the corporation's business, if the corporation's "primary purpose" in making the payment was not to aid in the acquisition of the partnership's assets, a clearly capital expenditure. 418 F. 2d, pp. 596-597.

Subsequent to the decisions in Five Star, Capitol Indemnity Insurance and Smith, however, the Supreme Court decided Woodward v. Commissioner, 397 U.S. 572 (1970). At issue in Woodward was the characterization of litigation expenses in a stock valuation case where majority shareholders were buying out minority interests at "real value." There, the Court recognized the well-established rule that expenses attendant upon the acquisition of a capital asset are nondeductible capital expenditures and decided that the deductibility issue turned on "whether the origin of the claim * * * is in the process of acquisition itself." 397 U.S., p. 577. The court specifically rejected a test similar to that stated in Smith which turned on the taxpayer's "primary purpose" in undertaking the expense. The rationale adopted by

the Court in Woodward stemmed from the Supreme Court's earlier decision in United States v. Gilmore, 372 U.S. 39 (1903), where the test based on the "origin and character" of the claim was first enunciated with respect to distinguishing business from personal expenses.

Whatever the merits of Five Star, Smith and Capitol Indemnity Insurance prior to Woodward, it is clear that the ongoing viability of those decisions is seriously undermined by the "origin and character" test. See Bittker and Eustice, Federal Income Taxation of Corporations and Shareholders (3rd ed.) p. 5-13. It follows that where the origin of an expense is essentially in a capital transaction, then such an expense simply cannot be deductible under Section 162.

Indeed, the Fifth Circuit, the court which had previously decided Smith, severely limited the applicability of those decisions in light of Woodward in Jim Walter Corp. v. United States, 498 F. 2d 631 (1974). There, the taxpayer corporation repurchased certain of its outstanding warrants which permitted holders to purchase the corporation's stock. The corporation repurchased some of these warrants to facilitate a public offering of its shares in the course of a recapitalization. Applying the Woodward test, the Fifth Circuit found that the origin of the corporation's repurchase payments lay in its recapitalization efforts, rendering the payments part of a capital transaction and nondeductible. The court in Jim Walter Corporation rejected the argument that Five Star and Smith permit a business deduction for any payment that

serves a business purpose; the court construed Woodward and Gilmore as precluding a focus on the corporation's purposes and the consequences to its business if the payment was or was not made. 498 F. 2d, p. 637. See also Estate of Meade v. Commissioner, supra, pp. 165-168. As the Tax Court correctly stated (R. 24-25), Jim Walter Corporation limits the applicability of the Five Star result to those instances where the very survival of the taxpayer corporation depends upon the making of the payment, 498 F. 2d, p. 639. The only other cases reaching this issue with respect to a repurchase by a corporation of its own stock have reached similar results. See H. and G. Industries, Inc. v. Commissioner, supra; Richmond, Fredericksburg & Potomac R. v. Commissioner, 528 F. 2d 917, 920 (C.A. 4, 1975).

The Tax Court found (R. 25) that the origin and character of Harder Tree's purchase of its 22 shares from Rogers was to facilitate the merger of Harder Tree with the other Harder companies. The record strongly supports this finding. Both Mr. Harder and Keith L. Baker, the Harder companies' outside accountant, testified that the onerous nature of the stock option agreement between Harder Tree and Rogers did not become apparent until discussions concerning the possibility of merging all of the Harder companies were underway. (R. 49-50, 64-65.) Baker then prepared a memo to Mr. Harder advising that the stock option agreement be renegotiated. One of the principal reasons for this suggestion was that the existence of the agreement would, in the accountant's opinion, preclude major debt or equity financing for the merged companies.^{10/} (Pet. Ex. 31, p. 2.) As in Jim Walter

^{10/} Another reason given by the accountant included the difficulty in valuing Rogers' shares in the merged companies because the valuation formula in the stock option agreement was based on the sales of Harder Tree and Cardinal, and neither corporation would remain in existence after the merger. (Pet. Ex. 31, p. 2.)

Corporation, there was evidence adduced to show that the stock option agreement would be an impediment to a possible public offering of the newly-created corporation resulting from the merger. (R. 59.) While the accountant's memo suggested re-negotiation of the stock option agreement, there was further testimony to the effect that the Harders considered dissolving the agreement through legal action. (R. 79-81, 89, 103-104.) In any event, the taxpayer's own evidence clearly shows that Harder Tree exercised its rights under the stock option agreement to facilitate the merger of the Harder companies.^{11/} There is absolutely no indication in the record that this merger was sought to preserve a source of income for Harder Tree. To the contrary, Harder Tree's sales increased steadily in the years 1964-1966. (Stip. Ex. 18-R-20-T.) Rather, the merger of the Harder companies was sought in 1966 with the expectation of considerable administrative and accounting benefits, and with probable financial and tax benefits as well. (Pet. Ex. 31, p. 1.) Under these circumstances, there is no question that other expenses attendant upon the merger would be capitalized. See Bilar Tool & Die Corp. v. Commissioner, 530 F. 2d 708, 712-713 (C.A. 6, 1976); Gravois Planing Mill Co. v. Commissioner, 299 F. 2d 199, 206-

^{11/} In emphasizing the corporate financial planning considerations behind terminating Rogers' minority interest in Harder Tree, the Tax Court correctly distinguished (R. 26) the Five Star line of cases where outside pressures were brought to bear forcing the corporations' payments. The lack of such outside pressure in the instant case serves only to underscore the intracorporate nature of the transaction.

209 (C.A. 8, 1962); Mills Estate v. Commissioner, 206 F. 2d 244, 246 (C.A. 2, 1953); 4A Mertens, supra, § 25.35. See also Briarcliff Candy Corp. v. Commissioner, 475 F. 2d 775, 782, 787 (C.A. 2, 1973). Similarly, there is no basis for expensing a payment made by Harder Tree--a constituent corporation of the merger--to facilitate the merger.

The Tax Court's determination under the Woodward test is essentially dispositive of the business expense issue before this Court. In an effort to upset the court's decision in this regard, however, the taxpayer (Br. 39-40) argues that the focus should be upon the Harders' subjective intent at the time of execution of the stock option agreement and at the time of the payment to Rogers. As noted, supra, the taxpayer made no showing that the stock option agreement caused a drain on Harder Tree. Moreover, the taxpayer's resort to the subjective intentions of the Harders smacks of the "primary purpose" test espoused in Smith and flatly rejected in Woodward (397 U.S., p. 577) and Jim Walter Corp. (498 F. 2d, p. 639).^{12/}

Assuming, however, if only for the sake of argument, that there remains some vitality to the Five Star ruling that a corporation's purchase its stock from shareholder can be a deductible business

^{12/} Even in cases where a taxpayer's "motivation" is significant, the Supreme Court has emphasized that such motivation should be determined pursuant to the objective facts surrounding the transaction in question and not upon the self-serving statements of the principals. See United States v. Generes, 405 U.S. 93, 106-107 (1972).

expense, the Tax Court correctly found that the taxpayer did not satisfy the prerequisite for qualification under that principle, that the purchase was absolutely necessary to the survival of Harder Tree. The factors cited by the taxpayer (Br. 40-44) to contradict the court's finding shed little light on the underlying transaction. First, and perhaps most significantly, the taxpayer urges that the onerous nature of the stock option agreement weighed so heavily upon Harder Tree that the buy-out was necessary to "get rid" of Rogers and Cardinal.^{13/} Such a conclusion is entirely unsupported by the record. If Harder Tree regarded Cardinal as an unprofitable enterprise, it could have dissolved Cardinal without taking any action whatsoever with respect to Rogers' interest in Harder Tree. Indeed, Mr. Harder testified that the dissolution of Cardinal was essential to the accomplishment of the merger. (R. 78.) Nonetheless, the Tax Court was entirely correct (R. 25-29) in distinguishing between Harder Tree's "getting rid" of Cardinal and its elimination of Rogers' minority interest to facilitate the merger. While both paved the way for the merger, neither was inextricably linked to the other. The taxpayer should, accordingly, be rebuffed in its attempt to link the dissolution to Cardinal with the purchase of Rogers' stock.

In its attempt to show that Harder Tree's survival was at stake, the taxpayer (Br. 42) seriously misconstrues the accountant's memorandum concerning the renegotiation of the stock option agreement.

^{13/} The taxpayer did not raise the "survival" issue until it submitted its post-trial brief in the court below. Presumably, the evidence adduced in the Tax Court was directed at supporting the other issues raised in its petition and in the opening statement (Tr. 12) of its counsel. In any event, the record made by the taxpayer below simply will not support a finding that Harder Tree's business "survival" mandated the purchase of Rogers' shares.

(Pet. Ex. 31.) In discussing the valuation formula contained in the agreement, the memorandum states that a valuation of a corporation's stock based on "unprofitable sales"^{14/} is not a proper valuation method, particularly where the corporation "could not survive" without "infusions of capital by its parent." (Pet. Ex. 31, p. 2.) The "survival" reference here is specifically to Cardinal and not to Harder Tree, the parent which allegedly made (to some unknown extent) these infusions of capital.

Likewise, the taxpayer misconceives (Br. 42-43) the significance of the Harders' testimony that the payment was made solely to avoid possible extended litigation with the Valentines over the rescission of the stock option agreement. The Harders stated that such litigation would put them "out of business." (R. 81, 89.) But this testimony is relevant only in terms of the Harders' proposed merger in 1966 and 1967. If such merger plans had not come up, Harder Tree would have remained in business as before and there would have been no need to terminate Rogers' interest. Accordingly, the "origin" of payment was in the merger plans and did not relate to Harder Tree's survival as a business entity.

^{14/} This statement by the accountant in his memorandum of November 10, 1966, demonstrates the true post-transactional nature of the analysis that abounds in the taxpayer's case. The merger of Old Cardinal into Harder Tree, the simultaneous creation of Cardinal and the signing of the stock option agreement occurred on July 31, 1964. (Stip. Exs. 7-G, 9-I.) There was no way of knowing at that time how successful Cardinal might be, although Mr. Harder testified that he thought "it had no great prospects of a huge success." (R. 76.) From the standpoint of gross sales, it appears that Mr. Harder underestimated Cardinal's potential (Cardinal and Old Cardinal had combined sales of about \$120,000 in 1964 (Stip. Exs. 23-W, 24-X), with Cardinal's sales increasing dramatically to \$542,000 in 1966 (Stip. Ex. 26-2)). Cardinal also showed a slight profit in 1966, and maintained high sales figures even through 1967, the year of its dissolution. (Stip. Exs. 26-Z, 27-AA.) Accordingly, the accountant's memorandum in 1966 can in no way be reflective of the objective facts prevailing in 1964 when the stock option agreement was executed.

Finally, the taxpayer (Br. 41) attempts to link Harder Tree's survival to Rogers' rights under the employment agreement and the stock option agreement by arguing that Rogers would "obviously" have exercised his rights under the stock agreement within two weeks of his termination as an employee. This contention is refuted by the taxpayer's own evidence to the effect that, when it became clear that Harder Tree wanted to terminate Rogers' employment and rescind the stock option agreement, the Harders were unsuccessful in their attempts to renegotiate the latter. (R. 43.) Clearly, Rogers wanted to maintain his interest in Harder Tree and its successor corporation.^{15/} In light of the urgent tenor of the accountant's recommendation to renegotiate the stock agreement, and Harder Tree's rapid purchase of the stock to facilitate the merger, it advances the taxpayer's case little to suggest that Harder Tree could "survive" only by exercising its option to purchase Roger's stock after terminating his employment.^{16/}

^{15/} The taxpayer failed to call Rogers as a witness below so his intentions are solely a matter of conjecture at this stage. The Tax Court (R. 27) correctly construed the stock option agreement as requiring no payment by Harder Tree had Rogers wanted to maintain his interest in the company after being terminated as an employee. (Stip. Ex. 9-I.)

^{16/} The taxpayer (Br. 21, 41-42) attempts to demonstrate the onerous nature of the stock option agreement by stating that Harder Tree borrowed \$100,000 from Harder Extermination Service, Inc. to make the payment. The taxpayer further represents that Mr. Harder initially loaned the money to Harder Extermination. As shown, supra, the harshness of the terms of the stock option agreement became evident only after the Cardinal operation proved to be unprofitable. But the relevant consideration concerning the size of the payment is that it was made to terminate Rogers' interest in Harder Tree for purposes of the later merger, and not to insure the business survival of Harder Tree.

Underlying the taxpayer's argument throughout this case is its belief that the valuation formula in the stock option agreement was unfairly drafted by Valentine to place an excessively high value on the stock. (Stip. Ex. 9-I, par. 5.) Indeed, the Tax Court viewed the valuation formula as a "bad bargain" for Harder Tree. (R. 25.) While the court below correctly attached no significance to this fact in the context of this case, the admitted facts surrounding the execution of the merger agreement considerably mitigate any unfairness which might have emanated from Valentine's possible favoring of Rogers in drafting the documents. It is undisputed that both Mr. Harder and Frank read the stock option agreement before signing the "agreement for merger" on July 23, 1964. (R. 9, 73, 86-87.) Frank testified that he thought the valuation formula would yield a value for Rogers' stock of about \$12,000. (R. 87.) The figures in the record defy such a conclusion. Harder Tree's gross sales for 1964 were \$350,480.93. (Stip. Ex. 18-R.) The Cardinal companies' combined sales for 1964 were about \$120,000. (R. 23-W, 24-X.) While these figures were reported after 1964, the record contains no sales figures for 1963, the year prior to the initial merger. But it would be safe to assume that the 1964 figures were at least representative of those available to the Harders when negotiating the merger in 1964. In light of Rogers' 11 percent interest in Harder Tree pursuant to the 1964 merger, the simple application of this percentage to the above figures would have

yielded a valuation far above that cited by Frank.^{17/} Moreover, the record indicates that Old Cardinal was not an abundantly profitable enterprise at the time of the merger (Stip. Ex. 23-W) so any reference to gross sales as the basis for establishing the value of the stock should have triggered an inquiry by the Harders^{18/} upon even a cursory inspection of the document.

^{17/} Mr. Harder, as the 89% shareholder of Harder Tree after the 1964 merger, actually possessed considerable leverage under the valuation formula in the stock option agreement. In that formula the purchase price of the stock was determined by multiplying the combined gross sales of Harder Tree and its subsidiary by a fraction composed of the number of shares being sold as the numerator and the total outstanding shares as the denominator. (Stip. Ex. 9-I, par. 5.) While the agreement protected Rogers against dilution of his interest through reorganization (par. 7), it made no reference to the corporation's selling more of its authorized shares. Mr. Harder could control the sale of such stock, thereby potentially controlling the number of outstanding shares of Harder Tree. An increase in the number of outstanding shares would lessen the purchase price to be paid Rogers under the formula.

^{18/} The Harders would not have been powerless to change the formula prior to final execution. The merger was not finalized until July 31, 1964. (Stip. Exs. 2-B (Ex. 4, p. 4), 6-F, 10-J (minutes for board meeting of July 31, 1964).) The Harders had the full opportunity to have the documents reviewed in the week between the signing of the agreement for merger and the execution of the final documents. (R. 75-76; Pet. Ex. 30, pp. 13-15.) Upon signing the agreement for merger on July 23, the Harders could avoid entering into the merger, without possible legal liability, only with Rogers' consent. (Stip. Ex. 2-B (ex. E, par. 3(b).) The representation in the agreement for merger regarding the stock option agreement indicated, however, that the agreement would be executed along with the merger plan "in substantially the form" as that attached to the agreement. (Stip. Ex. 2-B, par. 5.) The gross sales factor was present in that document, and the word "substantially" shows that some bargaining could have ensued on the formula prior to July 31.

The tax consequences of a transaction are generally governed by the terms of the documents executed by the parties on matters that would normally be the subject of bargaining. See, e.g., Ullman v. Commissioner, 264 F. 2d 305 (C.A. 2, 1959); Commissioner v. Danielson, 378 F. 2d 771 (C.A. 3, 1967), cert. denied, 389 U.S. 858 (1967). This should be particularly applicable where, as here, the party which initiated the transaction and had the strongest bargaining position is attempting to alter what would appear to be the normal tax consequences of the contract. (R. 67-69, 84-85.)

2. No part of Harder Tree's payment to Rogers can be characterized as "reasonable compensation" deductible under Section 162(a)(1)

As an alternative argument under Section 162, the taxpayer (Br. 44-46) contends that the payment to Rogers qualifies as deductible compensation to the extent that the payment exceeded the fair market value of the stock. The Tax Court disposed of this contention (R. 26-28) in the course of its findings that the purchase of the stock stemmed from the elimination of Rogers' minority equity interest in Harder Tree to facilitate the merger. ^{19/}

^{19/} By deciding the case on this basis, the Tax Court did not deal with the merits of the evidence adduced by the taxpayer regarding the valuation of the stock. Similarly, this Court need not reach the valuation question if it affirms the Tax Court's decision. In any event, the taxpayer's evidence on the valuation question was quite cursory in nature and would not withstand close analysis. The taxpayer contends that the value of the Harder Tree shares purchased from Rogers was \$4,872. (Pet. Ex. 34, Sch. 7.) This figure was based on a brief comparison of Harder Tree and Cardinals' balance sheets with financial information, available through Standard & Poor's, relating to two publicly-held corporations in the maintenance business. (Tr. 108; Pet. Ex. 34.) Notwithstanding that these corporations operated nationally and

Accordingly, the prior analysis, supra, of the correctness of the lower court's decision under the "origin and character" of the claim test is dispositive of this contention by the taxpayer. Accordingly, the termination of his employment was simply a pre-condition to the triggering of Harder Tree's purchase rights under the stock agreement.^{20/}

The taxpayer contends (Br. 44) that there is an inconsistency between the Tax Court's ultimate finding and its additional finding (R. 27) that the termination of Rogers' employment and the elimination of his equity interest in Harder Tree were inseparable elements of the payment. Unquestionably, the parties' respective rights under the stock option agreement were tied to the termination of Rogers' employment with Harder Tree. (Stip. Ex. 9-I.) But the Tax Court (R. 27) correctly viewed the origin of the stock purchase to be in the need to eliminate Rogers' equity interest.

19/ (continued):

had sales and assets far in excess of Harder Tree's (Tr. 111-113, Pet. Ex. 34), the taxpayer's valuation expert conceded that the comparison corporations were not even primarily engaged in Harder Tree's line of business (extermination). (R. 67-68; Tr. 114.) In addition, the expert only superficially treated many of the factors cited by that very expert as bearing on the valuation of corporate stock. (R. 115-116.) Even assuming, however, that the expert's testimony should be given some weight, the "compensation" deduction must nonetheless be denied the taxpayer since no part of the payment to Rogers was shown to have been "reasonable" in amount (see discussion, infra).

20/ The Tax Court found (R. 27) that nothing would have been paid to Rogers (under the stock option agreement) upon the mere termination of his employment. Harder Tree made the payment only after exercising its rights under the agreement. In this regard, the taxpayer suggests again (Br. 45) that such a payment was inevitable because the possibility of Rogers' not requiring Harder Tree to

The upshot of the taxpayer's argument is that the link between Rogers' employment and the parties' rights under the stock agreement requires the instant payment to be treated as an employment-related expense. Such a proposition, if accepted, could lead to fairly bizarre results since a taxpayer could assure business expense treatment for stock purchase transactions from its employees by the artifice of tying such transactions in some way to the seller's employment. Moreover, this reasoning flies in the face of the "origin and character" of the claim test prescribed in Gilmore and Woodward and properly adopted by the court below. The case of William C. Atwater & Co. v. Commissioner, 10 T.C. 218 (1948), cited by the taxpayer (Br. 45), only serves to show the weakness in its position.

In Atwater, the taxpayer corporation originally paid a monthly cash bonus to its employees based on profits. Subsequently, the corporation discontinued the bonus plan and substituted a stock purchase plan whereby the employees were given rights to purchase the corporation's stock on very advantageous terms. The purchase

20/ (continued):

repurchase the shares was "economically remote." As noted, supra, however, there is no evidence in the record to indicate what Rogers intended to do upon termination of his employment. He may well have preferred to maintain an equity interest in the merged Harder companies, an option clearly open to him under the agreement. (Stip. Ex. 9-I, p. 7.) In any event, the urgency to act was amply demonstrated here by Harder Tree's rapid purchase of the stock.

agreement provided that, in the case of a cessation of employment, the employee's stock had to be resold to the corporation pursuant to a prescribed pricing formula. 10 T.C., pp. 222-223. One of the corporate employee's built up considerable stock holdings under this plan; upon leaving the corporation, and after litigation, he received a substantial sum under the repurchase provision of the stock agreement. The Tax Court permitted the corporation to treat this payment as a business expense, since the initial sale and later reacquisition of the stock were there viewed as "essential elements of an employment contract * * *." 10 T.C., p. 245.

Notwithstanding that Atwater was not decided under the Woodward test, Atwater is clearly distinguishable from the case at bar. First, whereas in Atwater the stock purchase agreement was tied to existing employment arrangements as a substitute for a cash bonus, the stock rights here were created pursuant to a merger of Old Cardinal into Harder Tree, whereby Rogers exchanged his Old Cardinal shares for Harder Tree shares (Stip. Ex. 6-F, p. 3), and these rights were tied to Rogers' employment only insofar as the termination of his employment triggered the parties' rights under the agreement. The parties entered into a separate employment agreement (Stip. Ex. 8-H) in which the terms of Rogers' compensation as an employee were clearly defined. Accordingly, this case presents the converse of the Atwater situation. There, the employer-employee relationship gave rise to the stock rights; but here the 1964 merger and Rogers' acquisition

of stock ownership in Harder Tree gave rise to his employment by Harder Tree. And, while in Atwater the employee left the corporation and thereby forced the corporation to repurchase the stock, here Harder Tree principally sought to eliminate Rogers' equity interest and terminated Rogers' employment largely to achieve that end. It is apparent, then, that Atwater lends no support to the taxpayer here.

Finally, the taxpayer must fail on this issue since it adduced no evidence to support finding that any part of the payment of \$100,677.44 to Rogers, assuming it can be characterized as compensation at all, was "reasonable" in amount and paid for personal services actually rendered. Section 162(a)(1); Treasury Regulations on Income Tax (1954 Code) § 1.162-7(a)(26 C.F.R.). Two of the statutory prerequisites to a business deduction for compensation paid under Section 162 are that the compensation relate to "personal services actually rendered" and that it be "reasonable" in amount. Botany Mills v. United States, 278 U.S. 282, 290-293 (1929); Darco Realty Corp. v. Commissioner, 301 F. 2d 190, 191 (C.A. 2, 1962); Gilman Paper Co. v. Commissioner, 284 F. 2d 697, 699 (C.A. 2, 1960). The instant taxpayer fails on both counts.

While the taxpayer correctly argues (Br. 46) that a deduction may be taken for compensation paid currently but based on services provided in prior tax years, it is likewise well established

that the taxpayer must nonetheless prove that specific payments do, in fact, relate to services rendered in prior years. See Standard Asbestos Mfg. & Insulating Co. v. Commissioner, 276 F. 2d 292, 293 (C.A. 8, 1960). No such showing was made here and, indeed, the record dictates a contrary conclusion. At the time of the merger in 1964, Harder Tree entered into a separate employment agreement with Rogers. (Stip. Ex. 8-H.) This agreement prescribed a monthly salary for Rogers of about \$1,000. (R. 10; Stip. Ex. 8-H, p. 3.) Authorization for Harder Tree's entering into this agreement was specifically made at a board of directors meeting on July 23, 1964, as reflected in the minutes of that meeting. (Stip. Ex. 10-J (meeting of July 23, 1964).) The taxpayer adduced absolutely no testimony from Harder Tree's officers indicating that the 1967 payment to Rogers should be considered compensation for services rendered in prior years. Understandably, the payment was not treated as compensation on Harder Tree's tax return for 1967 (Stip. Ex. 21-U), and was reflected on all pertinent corporate records as a payment, pursuant to the stock option agreement (Stip. Ex. 9-I), to repurchase Rogers' 22 shares in order to eliminate his interest in Harder Tree. (Stip. Exs. 10-J (minutes of December 1, 1966, meeting), 13-M, 16-P.) The inevitable conclusion to be drawn from the record, then, is that Harder Tree "compensated" Rogers on a monthly basis and made the extraordinary payment to him in 1967 strictly for the repurchase of his stock.

The taxpayer's claimed "compensation" deduction under Section 162 must likewise fail because there is no evidence to support a finding that the \$100,000 payment would be "reasonable" in amount. The courts have developed a number of criteria to determine the reasonableness of compensation, including the quality of the employee's work, prevailing rates of compensation in comparable businesses and the rate of compensation paid to the employee in recent years. See Mayson Mfg. Co. v. Commissioner, 178 F. 2d 115, 119 (C.A. 6, 1949); Irby Construction Co. v. United States, 290 F. 2d 824, 826 (Ct. Cl., 1961); 4A Mertens, supra, § 25.69. Looking to the applications of these factors to the instant record, it is undisputed that Harder Tree compensated Rogers at a rate of approximately \$12,000 per year for the years 1964 through 1966; for similar work prior to the 1964 merger, Rogers was compensated by Old Cardinal at an annual rate of less than \$12,000 (Stip. Ex. 23-W, p. 2); and, perhaps most significantly, the quality of Rogers' services, in light of the fact that Cardinal's operation improved but was only marginally profitable from 1964 through 1967 in spite of dramatic increases in gross sales (R. 12), was clearly not such as to merit a "bonus" of almost \$100,000. In this respect, the Harders' testimony to the effect that they wanted to "get rid" of Rogers and the Cardinal operation at any cost (R. 81-82, 89) speaks volumes on the question of the value of Rogers' services for purposes of judging the reasonableness of the extremely high "compensation" deduction claimed here.

- C. The Tax Court correctly decided that Harder Tree was not entitled to an ordinary loss deduction under Section 165(g)(3) on the worthlessness of Cardinal's stock to the extent of the payment to Rogers, and that the substance as well as the form of Harder Tree's payment to Rogers was a repurchase of its stock and not a capital contribution to Cardinal

The taxpayer (Br. 25-29) reasserts the contention in this Court that Harder Tree's payment to Rogers for the repurchase of his Harder Tree stock was, in substance, an added investment in Cardinal, its wholly owned subsidiary. Accordingly, the taxpayer argues that it should be entitled to an ordinary loss deduction for the full amount of the payment under Section 165(g)(3) of the Code, which prescribes noncapital loss treatment for the loss by a parent corporation on the total worthlessness of its subsidiary's stock. See 875 Park Avenue Co. v. Commissioner, 217 F. 2d 699, 701 (C.A. 2, 1954); Treasury Regulations Section 1.165-5(d)(1), Appendix infra. Notwithstanding that the taxpayer failed to demonstrate its entitlement to this deduction, as will be discussed more fully, infra, the Tax Court's findings regarding the origin of the transaction are fully dispositive of this issue.

The taxpayer would have this Court believe that Harder Tree was somehow required to buy out Rogers' interest in order to dissolve the Cardinal operation. Even if this were true, it is difficult to conceive how a payment to Rogers, who was a minority

shareholder in Harder Tree and owned no stock in Cardinal, could under the facts here presented constitute a contribution to Cardinal's capital by Harder Tree.^{21/}

^{21/} While the Commissioner initially permitted Harder Tree an ordinary loss deduction on its admitted investment in Cardinal (not including the subject payment to Rogers) (R. 38-40; Pet., Ex. A (p. 4)), it would appear that even this deduction was improvidently granted, although that amount is not in dispute here. For instance, Cardinal clearly had some going concern value in 1967. Its gross sales had increased from approximately \$120,000 in 1964 (Stip. Exs. 23-W, 24-X) to \$542,085 in 1966. (Stip. Ex. 26-2.) In fact, Cardinal's sales in 1967, the year of dissolution, amounted to \$399,455. (Stip. Ex. 27-AA.) Cardinal listed assets as of January 1, 1967, in the amount of \$97,154, and likewise showed an excess of assets over liabilities at that time. Indeed, even the evidence adduced by the taxpayer's own expert showed that the Cardinal operation added to the value of Roger's Harder Tree shares in January, 1967 (R. 104; Pet. Ex. 34, sch. 7), and the taxpayer showed no reason why the Cardinal operation depreciated in value after that time. Accordingly, as the Tax Court noted (R. 20), the taxpayer's own evidence was entirely inconsistent with its contention that Cardinal's stock became wholly worthless in 1967. See Treasury Regulations Section 1.165-5(d) (1).

Presumably, the taxpayer relies on the mere dissolution of Cardinal in late 1967 to demonstrate the total worthlessness of its stock. (Stip. Ex. 28-BB.) It is well established that a taxpayer must show worthlessness by some "identifiable event" within the taxable year. 875 Park Avenue Co. v. Commissioner, 217 F. 2d 699, 701 (C.A. 2, 1954); Boesel v. Commissioner, 208 F. 2d 817, 819 (C.A. 2, 1954); Treasury Regulations § 1.165-1(b). Where this event is the liquidation or dissolution of a corporation, the taxpayer must then show that the dissolution was not, or could not have been, accompanied by a distribution. Leicht v. Commissioner, 137 F. 2d 433, 437 (C.A. 8, 1943). This is particularly true where, as here, the corporation appeared to have liquidating value based on an excess of assets over liabilities, and some going concern value based on its high sales activity. See Morton v. Commissioner, 38 B.T.A. 1270, 1279-1280 (1938), aff'd, 112 F. 2d 320 (C.A. 7, 1940). The instant taxpayer failed, however, to adduce any evidence as to the liquidating value of Cardinal. Indeed, the record contains nothing but questions in this regard.

The minutes of Cardinal's board of directors' meeting of September 1, 1967, show that Cardinal's "inventory, supplies and accounts" were sold to a non-Harder company. (Stip. Ex. 11-K; see also Stip. Ex. 10-J (minutes of meeting on September 1, 1967).) But no documentary evidence was presented showing the purchase price for these items. Since Cardinal began 1967 with a positive

The taxpayer quotes (Br. 28) the Harders' testimony to the effect that the payment was made to "get rid" of Rogers and Cardinal. But as shown, supra, the buy-out of Rogers and the dissolution of Cardinal were mutually exclusive events, both in time and in legal effect. (R. 16-17.) Under no circumstances was Harder Tree required to buy out Rogers in order to dissolve Cardinal. The stock option agreement (Stip. Ex. 9-I) defines the parties rights without any reference to Cardinal. As a result, the taxpayer's statement (Br. 29) that the "real substance of the transaction was an additional investment to dissolve a losing entity" has absolutely no basis in the record. Indeed, if Harder Tree had made additional capital contributions to Cardinal of the type here claimed, the latter's business operation may well have functioned more profitably, thereby obviating the perceived need for dissolution.

The Tax Court's finding (R. 24-25) that the origin of Harder Tree's payment to Rogers was in Harder Tree's desire to eliminate Rogers' equity interest for purposes of the merger reflects the substance of the transaction as shown in the record. No weight should be accorded the taxpayer's efforts, pursuant to a circuitous post-transactional analysis, to attach an illusory substance to an otherwise straight-forward transaction.

21/ (continued):

net worth, and its sales remained high during the year (Stip. Ex. 27-AA), it can be safely presumed that Cardinal's assets had some value. Indeed, Cardinal listed "accounts" of \$67,954 at the beginning of 1967. (Stip. Ex. 27-AA, p. 4.) The only further evidence in the record concerning the Cardinal operation consists of its formal dissolution papers. (Stip. Exs. 11-K (meeting of December 19, 1967), 28-BB.) But the record is devoid of any evidence showing the existence or extent of any distribution to Harder Tree at Cardinal's dissolution.

CONCLUSION

The decision of the Tax Court is correct and should be affirmed.

Respectfully submitted,

M. CARR FERGUSON,
Assistant Attorney General,

GILBERT E. ANDREWS,
JONATHAN S. COHEN,
JAMES E. CROWE, JR.,
Attorneys,
Tax Division,
Department of Justice,
Washington, D. C. 20530.

AUGUST, 1977.

CERTIFICATE OF SERVICE

It is hereby certified that service of this brief has been made on opposing counsel by mailing four copies thereof on this 25th day of August, 1977, in an envelope, with postage prepaid, properly addressed to him as follows:

John K. Antholis, Esquire
Edwards & Antholis
Suite 2900
40 Wall Street
New York, New York 10005

Gilbert E. Andrews
GILBERT E. ANDREWS,
Attorney.

APPENDIX

Internal Revenue Code of 1954 (26 U.S.C.):

SEC. 162. TRADE OR BUSINESS EXPENSES.

In General.--There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including--

- (1) a reasonable allowance for salaries or other compensation for personal services actually rendered;

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SEC. 165. LOSSES.

(a) General Rule.--There shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise.

(b) Amount of Deduction.--For purposes of subsection (a), the basis for determining the amount of the deduction for any loss shall be the adjusted basis provided in section 1011 for determining the loss from the sale or other disposition of property.

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(g) Worthless Securities.--

(1) General rule.--If any security which is a capital asset becomes worthless during the taxable year, the loss resulting therefrom shall, for purposes of subtitle, be treated as a loss from the sale of exchange, on the last day of the taxable year, of a capital asset.

(2) Security defined.--For purposes of this subsection, the term "security" means--

(A) a share of stock in a corporation;

(B) a right to subscribe for, or to receive, a share of stock in a corporation; or

(C) a bond, debenture, note, or certificate, or other evidence of indebtedness, issued by a corporation or by a government or political subdivision thereof, with interest coupons or in registered form.

(3) Securities in affiliated corporation.--For purposes of paragraph (1), any security in a corporation affiliated with a taxpayer which is a domestic corporation shall not be treated as a capital asset. For purposes of the preceding sentence, a corporation shall be treated as affiliated with the taxpayer only if--

(A) at least 95 percent of each class of its stock is owned directly by the taxpayer, and

(B) [as amended by Sec. 7, Technical Amendments Act of 1958, P.L. 85-866, 72 Stat. 1606] more than 90 percent of the aggregate of its gross receipts for all taxable years has been from sources other than royalties, rents (except rents derived from rental of properties to employees of the corporation in the ordinary course of its operating business), dividends, interest (except interest received on deferred purchase price of operating assets sold), annuities, and gains from sales or exchanges of stocks and securities.

In computing gross receipts for purposes of the preceding sentence, gross receipts from sales or exchanges of stocks and securities shall be taken into account only to the extent of gains therefrom.

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SEC. 311. TAXABILITY OF CORPORATION ON DISTRIBUTION.

(a) General Rule.--Except as provided in subsections (b) and (c) of this section and section 453(d), no gain or loss shall be recognized to a corporation on the distribution, with respect to its stock, of--

(1) its stock (or rights to acquire its stock), or

(2) property.

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Treasury Regulations on Income Tax (1954 Code) (26 C.F.R.):

§ 1.162-7 Compensation for personal services.

(a) There may be included among the ordinary and necessary expenses paid or incurred in carrying on any trade or business a reasonable allowance for salaries or other compensation for personal services actually rendered. The test of deductibility in the case of compensation payments is whether they are reasonable and are in fact payments purely for services.

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§ 1.165-1 Losses.

(a) Allowance of deduction. Section 165(a) provides that, in computing taxable income under section 63, any loss actually sustained during the taxable year and not made good by insurance or some other form of compensation shall be allowed as a deduction subject to any provision of the internal revenue laws which prohibits or limits the amount of the deduction. This deduction for losses sustained shall be taken in accordance with section 165 and the regulations thereunder. For the disallowance of deductions for worthless securities issued by a political party, see § 1.271-1.

(b) Nature of loss allowable. To be allowable as a deduction under section 165(a), a loss must be evidenced by closed and completed transactions, fixed by identifiable events, and, except as otherwise provided in section 165(h) and § 1.165-11, relating to disaster losses, actually sustained during the taxable year. Only a bona fide loss is allowable. Substance and not mere form shall govern in determining a deductible loss.

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§ 1.165-5 Worthless securities.

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(b) Ordinary loss. If any security which is not a capital asset becomes wholly worthless during the taxable year, the loss resulting therefrom may be deducted under section 165(a) as an ordinary loss.

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(d) Loss on worthless securities of an affiliated corporation--(1) Deductible as an ordinary loss. If a taxpayer which is a domestic corporation owns any security of a domestic or foreign corporation which is affiliated with the taxpayer within the meaning of subparagraph (2) of this paragraph and such security becomes wholly worthless during the taxable year, the loss resulting therefrom may be deducted under section 165(a) as an ordinary loss in accordance with paragraph (b) of this section. The fact that the security is in fact a capital asset of the taxpayer is immaterial for this purpose, since section 165(g) (3) provides that such security shall be treated as though it were not a capital asset for the purposes of section 165(g) (1). A debt which becomes wholly worthless during the taxable year shall be allowed as an ordinary loss in accordance with the provisions of this subparagraph, to the extent that such debt is a security within the meaning of paragraph (a) (3) of this section.

(2) Affiliated corporation defined. For purposes of this paragraph a corporation shall be treated as affiliated with the taxpayer owning the security if--

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(ii) None of the stock of such corporation was acquired by the taxpayer solely for the purpose of converting a capital loss sustained by reason of the worthlessness of any such stock into an ordinary loss under section 165(g) (3), and

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